

# THE RELATIONSHIP BETWEEN RISK MANAGEMENT AND CAPITAL STRUCTURE OF PUBLIC LISTED COMPANIES IN MALAYSIA

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**Abstract:** - *This paper aims to explore the link between risk management and capital structure decisions in Malaysian PLCs. While traditional capital structure theories focus on tax shields, bankruptcy costs, and information asymmetry, the strategic planning of risk management in influencing firm financing decisions is often not mentioned explicitly, especially in emerging markets. Building on risk management theory and elaborating findings from the banking literature, we argue that good risk management practices allow firms to achieve an optimal capital structure through reallocation of risk rather than outright deleveraging. This article introduces two innovative ideas of Risk Management Sophistication and Financial Flexibility into a common theoretical structure. Risk Management Sophistication reflects the breadth and intensity of integration into decision making of risk management tools at the corporate level, and Financial Flexibility measures firms' ability to access and adjust financing following a shock. The model suggests that the MP of a firm has a direct impact on its CS decisions and this relation is mediated by financial flexibility. By examining Malaysian PLCs, this study seeks to add to capital structure and risk management literature by grounding these interactions within an emerging market environment exhibiting institutional impositions and evolving governance regimens. The implicit companies' group financing framework lays the theoretical foundation to the empirically testable categories and brings practical implications for corporate executives and policy makers regarding sustainable finance strategies.*

**Keywords:** *Risk management; Capital structure; Risk management sophistication; Financial flexibility; Malaysian public listed companies; Emerging markets*

## Introduction

Capital structure choice continues to be a focus of corporate finance, more so in emerging markets when firms are subject to greater volatility, institutional restrictions and governance. Malaysia's public listed companies (PLCs) operate in a market which is open, regulated by Bursa Malaysia and becoming more exposed to international financial risks. As a result, risk management has become an important part of the financing and leverage strategies pursued by firms. Most classical capital structure theories, including the Modigliani–Miller proposition, trade-off theory and pecking order theory, provide an explanation for leverage choices, yet they do not explicitly recognise the role of a dynamic risk management policy. Adapting the framework of Cebenoyan and Strahan (2004), which provides evidence that effective risk management permits banks to hold a lower level of capital buffer while undertaking riskier but profitable business activities, this conceptual paper extends this logic to non-financial Malaysian PLCs. It is argued in this paper that such Malaysian PLCs could potentially structure their capital use more efficiently by reallocating, rather than reducing risk.

Malaysian Public Listed Companies (PLCs) present a uniquely compelling context for investigating the intersection of risk management and capital structure due to the country's distinct regulatory evolution and vulnerability to macroeconomic volatility as an emerging market. Historically, the aftermath of the 1997 Asian Financial Crisis highlighted the severe vulnerabilities of highly leveraged capital structures, prompting Malaysia to implement robust, crisis-driven corporate governance reforms aimed at restoring investor confidence and stabilizing the capital market (Shim, 2006). Central to these institutional reforms is the Malaysian Code on Corporate Governance (MCCG), which explicitly mandates that boards of directors maintain sound internal controls and proactively oversee enterprise risks to prevent excessive and unmanaged leverage (Ishak et al., 2011). Because Malaysian PLCs operate within this stringent regulatory environment—where the integration of sophisticated Enterprise Risk Management (ERM) frameworks is not merely a voluntary strategic choice but a strict governance requirement that directly influences their overall cost of capital (Shad et al., 2022), they provide an ideal empirical setting. Examining this market allows for a clear observation of how mandated risk management capabilities transcend basic compliance, actively shaping financial flexibility and optimal capital structure decisions in the face of continuous regional and global economic shocks.

The logic of banking-based risk management, which demonstrates that financial institutions can optimize their capital structures by substituting capital buffers for enhanced risk controls, is highly transferable to non-financial firms. In the banking sector, mitigating risk exposures allows institutions to operate with thinner equity cushions and channel resources into more aggressive, profitable lending activities. For non-financial corporations, this principle manifests through Enterprise Risk Management (ERM) systems, which provide a holistic framework for identifying, measuring, and mitigating a broad spectrum of corporate risks (Nocco & Stulz, 2006). By proactively managing these exposures, non-financial firms can significantly reduce their cash flow volatility and mitigate the costs associated with financial distress. Consequently, just as banks lower their capital buffer requirements through advanced credit risk management, non-financial entities with robust ERM practices can reduce their reliance on precautionary cash or equity buffers. This unlocks the capacity to safely sustain higher leverage and invest in strategic growth opportunities, even in environments characterized by high complexity and uncertainty (Monazzam & Crawford, 2024).

While prior literature has extensively examined Enterprise Risk Management (ERM) and capital structure as distinct domains, a critical theoretical gap remains regarding the specific, dynamic mechanisms that link them within non-financial firms. Most existing corporate finance studies rely on discrete, binary proxies for risk management, such as the mere adoption of financial derivatives, which fundamentally fail to capture the strategic depth, maturity, and organizational integration of modern ERM frameworks (Bartram, Brown, & Conrad, 2011). Conversely, while ERM research acknowledges its broader positive impact on firm value and performance (Hoyt & Liebenberg, 2011), it rarely operationalizes how this qualitative sophistication actively reshapes long-term financing policies. This paper directly addresses this void by introducing "Risk Management Sophistication" and "Financial Flexibility" as intertwined constructs, mapping the precise intertemporal pathway through which advanced risk maturity translates into capital structure optimization. By explicitly extending the banking-centric logic of capital substitution (Cebenoyan & Strahan, 2004) to non-financial entities, this conceptual model provides a much-needed theoretical bridge. It moves the literature beyond static observations of hedging behavior to explain *how* deeply integrated risk oversight empowers firms which particularly in heavily regulated and volatile emerging markets, to systematically trade rigid capital buffers for strategic financial agility.

## Theoretical Background

### Capital Structure and Hedging

Conventional capital structure theories claim that firms weigh the tax advantages of debt against bankruptcy and agency costs (Kraus & Litzenberger, 1973). Yet, risk management theory states that firms do not hedge exposure so much to eliminate uncertainty as they wish to lower the cost of financial distress and external finance (Froot, Scharfstein & Stein, 1993; Froot & Stein, 1998).

Cebenoyan and Strahan (2004) find that banks that use advanced credit risk management tools hold lower capital and enjoy a lower level of risk-adjusted volatility, suggesting this relationship can be endogenous rather than an independent choice for the firm. The logic extends to non-financial firms that experience cash flow uncertainty, refinancing frictions and investment rigidities.

### The Risk Management in Non-Financial Firms

Previous research demonstrates that derivative-based corporate hedging increases firm value (Allayannis & Weston, 2001) and stabilises internal funds so firms can invest more (Minton & Schrand, 1999). For developing countries, where capital market imperfections are more severe, the role of risk management in determining leverage might be even more important.

### Conceptual Framework Development

The present study is a conceptual paper which aims to establish the basic concepts that connect corporate risk management practices with capital structure decisions by introducing two new suggested constructs that are specifically important for Malaysian PLCs. The framework stems from risk management theory as well as capital structure literature, which increasingly acknowledge the fact that financing decisions cannot be investigated without also considering firms' risk management strategies. Previous literature points to the fact that firms systematically engage in risk management not only to minimise cash flow volatility, but also

to lower the costs of financial distress, stabilize internal cash flows and enhance access to external capital by taking into account all the factors that influence their optimal level of hedging activity. Verdú (2013). Thus, this framework interprets risk management as a strategic tool that impacts how firms shape their capital structure and sustain it throughout time. Within the Malaysian context of PLCs in a developing market where capital markets are characterized by imperfections, regulatory oversight and impacted by global shocks, the nexus between risk management and CS is likely to be more pronounced.

At the heart of the model are two basic components: risk management and capital structure. Risk management processes relate to the financial and operational instruments used by firms in identifying, evaluating and controlling exposure to uncertainty. These applications are generally related to measures of financial risk (both at the firm and project level), which include how currency, interest rate, and commodity price risks are managed through the use of derivative products; how disruption in production processing or carry out business is controlled or avoided altogether and physical risk (all discussed in Allayannis & Weston, 2001; Minton & Schrand, 1999). Indeed, evidence suggests that companies pursuing a systematic approach to risk management exhibit lower cash flow volatility, leading to a mitigation of their dependence on expensive external financing and ensuring more stable investment and financing decisions (Smith & Stulz, 1985; Froot et al., 1993).

Capital structure in this framework is the strategic decision of firms, with respect to leverage and composition of debt maturity and dependence on internal or external sources of financing. Instead of final state, capital structure is a dynamic policy which depends on firms' risk control level and ability to resist the economic strike. Previous studies indicate that companies with more stable cash flows and lower risk would be able to withstand higher leverage and longer debt maturities without bearing any too large bankruptcy or agency costs (Kraus & Litzenberger, 1973; DeAngelo & DeAngelo, 2007). Carrying this logic further, the model suggests that with successful risk management, firms can trade away some risk controls for equity buffers, which then affects the choice of leverage and financial flexibility. This view is consistent with evidence from studies of individual financial and non-financial firms that show that the decision to hedge risk and the choice of capital structure are endogenously determined aspects of corporate financial strategy, rather than separate decisions (Froot & Stein, 1998; Cebenoyan & Strahan, 2004).

In addition to the classical risks associated with capital structure, more recent literature claims that institutional and country-specific elements also shape the financial policies of companies. In these environments, with their weaker investor protection, higher asymmetry of information between buyers and sellers and less developed capital markets, internal risk management mechanisms are crucial in underpinning decisions over gearing (Booth 2001a, 2001b; Fan 2012). Empirical evidence supports the idea that companies operating under such constraints rely more on conservative financing practices to take up the slack than their counterparts in more established economies. For Malaysian PLCs this view is particularly relevant as regulators tend to increase control over markets due to exposures to local and global economic volatility. There exists therefore an imperative closer alignment between strategies of mitigating risk and financing choices.

Additionally, corporate governance and firm-specific characteristics are important moderating variables in the relationship between risk management and capital structure. Studies have revealed that firms with stronger governance structures and higher managerial incentives to reduce risk tend to undertake more hedging activities, which support higher leverage and better debt-equity agreements (Tufano 1996, Bartram et al., 2011 ). Then firms employing companywide risk management (ERM) frameworks also seem to enjoy reduced labor volatility and credit ratings (Hoyt and Liebenberg 2011 ). These findings support the view that risk management should form part of strategic financial planning processes running throughout long term business strategy, rather than a stand-alone activity.

### **Proposed Constructs and Research Hypotheses**

To address the aforementioned gap, and also add to the current body of capital structure and risk management literature, this paper proposes two constructs grounded on theory: Risk Management Sophistication and Financial Flexibility, in order to explain how risk management can drive organizational strategic choices for capital structures within Malaysian public listed companies (PLCs). These variables are introduced to compensate for shortcomings in previous studies, which were merely concerned with the presence of risk management activities as opposed to their strategic intensity and financial effects.

Here is the reorganized and rewritten literature synthesis, structured to emphasize risk management as a strategic capability, capital structure as a dynamic policy, the unique challenges of emerging markets, and culminating in the strategic nexus between the two.

### **Proposed Constructs and Research Hypotheses**

To address the shortcomings of previous studies that primarily focus on the mere presence of risk management activities (e.g., discrete use of derivatives), this paper introduces two theoretically grounded constructs: Risk Management Sophistication (RMS) and Financial Flexibility. By exploring these constructs, this research explains how risk management drives organizational strategic choices for capital structures.

### **Risk Management as a Strategic Capability**

Unlike discrete measures of risk mitigation, Risk Management Sophistication (RMS) emphasizes the quality, breadth, and formal integration of risk management into a firm's overarching governance, strategy, and decision-making processes. It represents a shift from managing risks in silos to treating enterprise risk management (ERM) as a core organizational capability. This includes board-level risk oversight, internal quantification of risks, and the alignment of risk policy with corporate strategy.

Existing research argues that firms equipped with advanced, strategically integrated risk management capabilities are better positioned to measure, spread, and transfer risks across their operations. This systemic approach effectively reduces the volatility of operating cash flows and earnings (Hoyt & Liebenberg, 2011; Nocco & Stulz, 2006). Theoretically, integrated risk management ensures that internally generated funds are protected to support investment opportunities, thereby reducing a firm's dependence on expensive external capital (Froot & Stein, 1998). Furthermore, empirical evidence suggests that firms demonstrating sophisticated risk management are perceived as less risky by creditors, allowing them to secure borrowing at cheaper rates (Gordon, Loeb & Tseng, 2009).

### Capital Structure as a Dynamic Financing Policy

Modern corporate finance increasingly views capital structure not as a static end-state, but as a dynamic policy where Financial Flexibility is a primary objective rather than a mere after-effect of leverage decisions (DeAngelo & DeAngelo, 2007). Financial flexibility is defined as a firm's ability to access, reconfigure, and deploy financial resources such as unused debt capacity, liquidity cushions, and capital market access, at a low cost in response to internal or external shocks.

Hedging and risk mitigation play a critical role in facilitating this dynamic policy. By dampening earnings volatility and ensuring the smooth handling of cash flows, risk management reduces the probability of a firm encountering binding financing constraints, allowing it to maintain critical financial slack during economic downturns (Minton & Schrand, 1999; Gamba & Triantis, 2008). Building on banking literature, Cebenoyan and Strahan (2004) demonstrate that institutions utilizing advanced risk-management tools can operate safely with thinner capital cushions while remaining profitable. Applying this logic to non-financial firms, proactive risk management empowers organizations to structurally improve their financial flexibility, allowing them to safely alter their leverage decisions, debt structures, and financing policies without incurring prohibitive distress costs.

### The Role of the Emerging Market Context

The strategic interplay between risk management and dynamic capital structure is particularly critical in emerging markets, such as Malaysia. Firms in these environments frequently navigate higher economic instability, greater exposure to external shocks, and imperfect capital markets (Bhide, 1994).

Within the Malaysian context, recent corporate governance reforms place a heavy emphasis on board accountability and stringent risk oversight. Consequently, a higher level of risk management sophistication is not just a strategic advantage, but an institutional necessity. In such volatile environments, firms must reconcile aggressive growth motives with fundamental financial security. Advanced risk management systems allow these public-listed companies (PLCs) to replace restrictive, traditional capital cushions with formal, on-balance-sheet risk controls, enabling them to weather economic strikes and function at higher optimal leverage levels without facing catastrophic financial distress.

### The Strategic Nexus: Linking Risk Management and Capital Structure

Ultimately, risk management and capital structure are endogenously determined aspects of a unified corporate strategy. Risk management acts as the engine that generates strategic possibilities, assisting firms in becoming proactive rather than reactive in their dealings with uncertainty. By integrating sophisticated risk protocols, firms create vital financial flexibility through enhanced cash flow predictability and creditor security. In turn, this financial flexibility serves as the crucial mediating mechanism that allows businesses to convert their improved risk profile into tangible, strategic financing opportunities.

Based on this intertemporal pathway, this paper proposes the following hypotheses:

- **Proposition 1 (P1):** Risk management complexity is significantly related to aggressive but optimal capital structure choices in Malaysian public-listed firms.

- **Proposition 2 (P2):** Financial flexibility mediates the relationship between risk management practices and capital structure in Malaysia's public-listed companies.
- **Proposition 3 (P3):** The effect of risk management practices on capital structure decisions is more pronounced for firms with greater risk management sophistication and financial flexibility, as these elements simultaneously enhance the firm's momentum to maintain optimal financing structures.

## Methodology

As this study is structured as a conceptual paper, the methodology centres on an integrative literature review and theory synthesis rather than primary empirical data collection (Jaakkola, 2020). To construct the proposed framework and derive the testable propositions, a comprehensive examination of extant theoretical and empirical literature was conducted across the intersecting domains of corporate finance, enterprise risk management (ERM), and corporate governance. The research process fundamentally involved bridging distinct but complementary theoretical streams, specifically, adapting the banking-based capital buffer logic established by Cebenoyan and Strahan (2004) and translating it to the operational realities of non-financial corporations. By applying deductive reasoning, the study synthesizes these multidisciplinary insights to logically construct the pathways linking Risk Management Sophistication and Financial Flexibility to optimal capital structure choices. This methodological approach of conceptual adaptation allows for the formulation of a novel theoretical model that not only addresses identified gaps in classical capital structure theories but also provides a robust, testable foundation for future empirical investigations within the unique institutional context of Malaysian PLCs (Snyder, 2019).

## Discussion and Implications

This theoretical article contributes to knowledge about capital structure decisions by incorporating risk management into the corporate financing debate in a direct manner. Offering Risk Management Sophistication and Financial Flexibility as the main explanatory mechanisms, the framework addresses increasing pleas in chapter 1 to shift from a static, piecemeal perspective of capital structure to a strategic, systematic one. We conclude this section by discussing the theoretical, managerial and policy implications of the proposed framework as it applies to Malaysian PLCs specifically and emerging market contexts more generally.

### Theoretical Implications

Theoretically, the current study adds additional value to capital structure research by asserting that risk management functions as a basic factor influencing firms' financing policies rather than an ancillary or subsequent issue. Most conventional capital structure theories such as the trade-off theory and pecking order theory generally hold an external view of risk, which treat it as exogenous to financing choice or a constraint that should be reduced. Theoretical Framework This assumption is challenged by the proposed framework which views risk management as a strategic competence that gives firms the capacity to allocate and accommodate various risks, hence affecting their optimal leverage and financing capability (Froot et al., 1993; Froot & Stein, 1998).

Past empirical work that uses binary proxies for risk management such as the use of derivatives is extended by the introduction of Risk Management Sophistication. This construct captures

qualitative variations in firms' risk management maturity that, by and large, have not been addressed in capital structure studies through the emphasis on governance integration, strategic fit, and analytic ability. At the same time, the framework is consistent with enterprise risk management (ERM) theory by anointing risk management as a firm-wide activity that affects value and resource allocation (Nocco & Stulz, 2006; Hoyt & Liebenberg, 2011).

In addition, the mediating effect of Financial Flexibility contributes to capital structure theory by emphasizing an intertemporal pathway in which risk management influences financing decisions. Instead of considering financial flexibility as a buffer created by conservative leverage, this research views it as a strategic goal attainable through efficient risk management. This view is consistent with the dynamic capital structure models that focus on firms' leverage ability, preservation of borrowing flexibility and their reactions to uncertainty over time (Gamba & Triantis, 2008; DeAngelo & DeAngelo, 2007). Overall, the model links banking-centered risk management perspectives (Cebenoyan & Strahan, 2004) with non-financial corporate finance theory in an integrative way and provides a more generalizable account of leverage choices.

### **Managerial Implications**

The model has significant implications for corporate managers, in particular CFOs and risk officers, as well as members of the boards of directors among Malaysian PLCs. First, the results indicate that risk management can and should not be regarded as a "compliance" or passive type of discipline activity only, but rather as a strategic tool with direct impact on ability to finance and competitiveness in the long term. Companies that integrate more advanced risk-oriented systems into their decision-making framework are generally in a better position to maintain leverage levels at an excessive level and manage debt maturity structures, while reducing dependence on underlying expensive equity financing growth did not also bring corresponding financial distress risks.

Second, the focus on Financial Flexibility speaks to the importance of maintaining strategic financing alternatives in volatile times for business. Managers are taught to recognise liquidity cushions, debt headroom and market access as the result of actively managed risk decisions rather than innocent consequences of cautious strategies. In practice, it means that companies need to consider their hedging decisions, cash management and capital structure planning under a unified financial policy system.

Third, the model emphasizes the governance responsibility of boards and top management to integrate risk management into strategic planning. Board risk oversight, cross-functional risk committees, and transparent risk reporting may increase creditor confidence and decrease information asymmetry which improves firms' ability to bargain for better financing terms. In the case of Malaysian PLCs which are active in more volatile and global-integrated markets, such alignment may be especially important to ensure growth while ensuring downside protection.

### **Policy and Regulatory Implications**

From the policy perspective, the present framework provides implications for law and Policy makers as well as for market institutions interested in corporate financial instability and quality of governance. Embracing Bursa Malaysia and the regulatory authorities' continuous reforms

on risk governance and sustainability as well as integrated reporting in ASEAN. This article complements such efforts by discussing the significant risk management in improving financial resilience and capital structure efficiency for firms.

Regulators could also think of promoting better disclosure around the risk management maturity, governance structure and financial flexibility indicators of firms other than just leaning so aggressively on leverage ratios. Increased transparency can enhance market discipline because investors and creditors are able to more accurately evaluate firms' genuine risk absorptive capabilities. Further, policy initiatives (e.g., governance mandates or reporting standards) that encourage the adoption of enterprise-wide risk management policies can have indirect effects on corporate financing decisions toward a more efficient and possibly stable financial structure.

At a more general emerging market level the model provides a rationale for institutional development to support risk management capabilities that would reduce firms' demand for excess equity buffers, which could potentially lead to an inefficient allocation of capital and the use of some investments in macroeconomic expansion as well. By lowering the cost of debt funding at a controllable risk level, such policies could encourage corporate growth more sustainably while not causing systemic concern.

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